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UNCLAS SECTION 01 OF 03 TAIPEI 003235

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E.O. 12958: N/A

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SUBJECT: Taiwan Economy Slows in Third Quarter

SUMMARY

1. Taiwan's export and industrial production growth slowed in the third quarter, but economists still expect real GDP growth of nearly 6 percent this year, and above 4.5 percent next year. Overall, the economy should be a positive factor for the ruling party in the December legislative elections.

GDP Growth Mid-Range Among Asian Tigers

2. In spite of high oil prices (which economic planning officials think could cut GDP growth by 0.2 percent) and efforts to cool China's economic growth (China is Taiwan's largest trade partner), economists expect Taiwan to have real GDP growth of nearly 6 percent this year. They see 2005 growth above 4.5 percent with unemployment remaining below five percent. Taiwan's GDP rose 7.2 percent in the first half of this year, behind Singapore's 10 percent and Hong Kong's 9.6 percent, but above the 5.4 percent recorded in South Korea in the first half of this year. The IMF in September predicted average GDP growth for Asian NIEs of 5.5 percent for 2004 and 4.0 percent for 2005.

Trade Growth Still Rapid

3. Taiwan's export growth slowed in July and August to an annual rate of 23 percent, down from nearly 30 percent in April to June. Meanwhile, import growth slipped from 40 percent to 33 percent. Growing inventories of unsold goods contributed to a delay in projects intended to increase production. This slightly slowed the growth in imports of capital goods from 54 percent in the second quarter to a still rapid 32 percent in July-August 2004.

Slower Industrial Growth - Tech Sector Impact

4. The slowdown in exports contributed to high inventories in both finished products and intermediate goods. Consequently, manufacturing growth slowed from 15 percent in the first half to 10 percent in July-August. Growth rates for capital- and technology-intensive industries slipped from 19 percent in the first half to 13 percent in July-August. According to Central Bank of China (CBC) Economic Research Department Deputy Director Yeh Jong-chao, the slowdown is particularly significant for semiconductor and flat panel screen manufacturers. Citigroup Equity Research has lowered its 2004 and 2005 earning estimates for flat panel screen makers by more than 20 percent because of potential oversupply. However, iron, steel and petrochemicals have continued rapid growth due to strong demand in both local and foreign markets. China Steel, for example, expects strong demand for its products to continue into next year.

Investment: Weak Domestically, Strong Overseas

5. Inbound direct investment in July-August 2004 declined four percent from a year ago, down sharply from 28 percent growth in the first quarter and 56 percent growth in the second quarter. However, approved out-bound direct investment in July-August 2004 grew nearly 30 percent year-on-year. Approved investment to China was up 39 percent. Overseas investment to places other than China grew 2.6 percent in the second quarter, and ten percent in July-August 2004.

Portfolio Investment Down

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16. Partly in response to unsettling political and business events, foreign portfolio investors withdrew US\$3.7 billion from Taiwan in the second quarter. Net inward remittances in July-August 2004 were only US\$200 million, far less than the net inflow of US\$7.8 billion in the same period in 2003. The unsettling news included the large demonstrations after the March presidential election, and financial irregularities in listed companies uncovered by Taiwan Stock Exchange examiners. As a result of these incidents, Taiwan business firms' issuance of global depository receipts (GDRs) dropped to only half a billion of US dollars in July-August 2004.

#### Foreign Exchange Reserves Up Modestly

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17. With large capital outflows and fewer GDRs, Taiwan's accumulation of foreign exchange (forex) reserves slowed to US\$3.6 billion in the second quarter and US\$1.5 billion in July-August 2004, down from US\$16 billion in the last quarter of 2003 and US\$20 billion in the first quarter of 2004. Nevertheless, Taiwan's forex reserves as of August 2004 amounted to US\$231.6 billion, three times Taiwan's outstanding external debt of US\$75 billion (as of March 2004).

#### Oil and Inflation Prompt CBC to Raise Interest Rates

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18. Rising international oil prices pushed Taiwan's inflation rate to a six-year high of 3.3 percent in July and 2.5 percent in August of this year. This prompted CBC to raise interest rates for CBC-issued negotiable certificates of deposit from 1.075 percent to 1.085 percent, and the interest rate for overnight inter-bank call loans to 1.1 percent in late September. On October 1, CBC raised the discount rate and its interest rates for accommodations by 0.25 percentage points.

#### Implications for Taiwan's Economy

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19. The increase in prices and interest rates will slow Taiwan's economic growth by blunting the export sector's competitive edge, dampening the real estate market, and reducing private consumption. The extent of the impact will depend on how long these trends last, but Taiwan's Council for Economic Planning and Development (CEPD) has already cut 2004 growth estimates by 0.2 percent. Statistics Bureau officials believe seasonal factors are responsible for the unemployment rate rising to 4.7 percent in August. This is still lower than the 5.2 percent unemployment of a year ago.

110. According to Peng Shu-ling of the Chunghua Institution for Economic Research, Taiwan's economy is still performing well. August export orders grew 25.5 percent. Strong performance in the iron, steel, and petrochemical industries mitigates the downturn of the semiconductor and liquid crystal display manufacturers. A CEPD survey showed the percentage of business firms expecting better performance in three months increased from 12 percent in July to 18 percent in August. These generally favorable economic trends and optimistic expectations bode well for the ruling DPP party in the year-end legislative elections.

(Please see the website "Taipei.state.gov/ait\_s/econ/econ-web" for following tables:  
Appended Table 1 Major Economic Indicators for Jan-Aug 2004  
Appended Table 2 Economic Indicator Estimates for 2004  
Appended Table 3 Economic Indicator Forecasts for 2005  
Appended Table 4 Major Economic Indicator for 2001, 2002 & 2003.)  
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